#90, 18 December, 2000
A publication of the International Centre for Policy Studies

ICPS newsletter

Ukraine's pension system should be reformed

Pension systems should pursue two major goals: to ensure minimally permissible living standards for all retired people and to provide safety mechanisms which would allow employees to save resources for the post-retirement period of their life. However, a number of problems impede the achievement of these goals. Mitchell Wiener, an expert with the PADCO company, is researching the pension system of Ukraine. In his research, he forecasts the financial standing of Ukraine's Pension Fund assuming two scenarios. The first scenario presumes the preservation of current pension legislation, while the second one takes into account the adoption of a new law on the pension system by the Verkhovna Rada. Mr. Wiener pays special attention to the drawbacks of the current pension system and the difficulties which will appear when the new pension system is adopted. The results of this analysis are published in the new issue of the ICPS journal* Policy Studies*, which appeared in print this week

Why do we need pension systems?

Concern for the elderly has become a central part of government policy in Ukraine, as people are living longer and an ever-larger share of the population is of pensionable age. Many elderly people can no longer be expected to support themselves by working. Consequently, the following two major goals of the pension system have been determined:

- to guarantee a minimum standard of living for all old people; and
- to establish safe means through which working people can save money for their own retirement.

Unfortunately, the twin goals of the pension system often work against each other. This is one of the reasons why the debate over pension policy in Ukraine is so difficult.

There is no single pension program that overcomes all the mentioned problems. Therefore, most countries have developed pension systems that have separate parts: a solidarity system, a mandatory accumulation system, and a voluntary accumulation system.

The three-pillar pension system: International experience

The *solidarity system* ensures that everyone, regardless of how much or how little they worked, receives at least something after they retire.

Since such a solidarity, or welfare, system can usually afford to pay only small monthly benefits relative to prevailing wages (in the United States, Social Security payments are only 35% of an average income before retirement), the solidarity system is usually supplemented by other pension programs. These other programs allow people to accumulate savings for their own retirement. To overcome the problem that guaranteed benefits to the elderly discourage people from saving enough for their old age, these pension savings programs may be made mandatory.

Mandatory accumulation systems require working people to pay a certain amount of their wages into individual savings accounts. The money is invested, and participants are allowed to withdraw the money (plus the income earned on investments) only when they have reached retirement age.

For some people, particularly those who earn high wages and want to maintain their standard of living after retirement, the combination of benefits from the solidarity system and the mandatory accumulation system may not provide enough savings. For these people, a third type of pension program is often provided: a *voluntary accumulation system* that allows people to pay into individual accounts and withdraw the money (plus accumulated investment income) after retirement.

However, not all countries have taken this approach to pension reform. Some have tried to eliminate their solidarity systems entirely. At the same time, almost all Central and Eastern European countries have reformed their pension systems, choosing to introduce some combination of the three-pillar system.

What should be taken into account while reforming Ukraine's pension system?

Projections of pension benefit payments and revenues to the Pension Fund depend on making assumptions about what will happen to the Ukrainian economy and population in the future. Under the present legal structure, the Pension Fund of Ukraine will be in actuarial balance over the next 75 years and will show an overall surplus. This balance is achieved at the expense of a falling ratio of average pensions to average wages over time and, in the immediate future, of continued low pension benefits.

Despite the favourable financial projections for the current system, maintaining the current pension system unchanged is not an option. The present solidarity system fails to meet the following conditions:

- It must provide adequate minimum benefits relative to the poverty level.
- It must provide reasonable benefits relative to the contributions people pay.
- The system must be fiscally sustainable for the government in the short and long term.
- Administrative systems should be efficient, both in terms of collecting and distributing benefits and in minimising wastage, fraud, and abuse.
- The legal framework must support a sustainable system that does not require frequent amendments.

The present system fails to meet these conditions because of a number of problems:

- retirement ages are too low;
- too many workers receive privileged pensions;
- highly paid workers receive disproportionately small pensions;
- reporting systems encourage fraud or misrepresentation of work experience;

This week's events

"People's voice" is getting louder in the regions. On 18–19 December 2000, ICPS's "People's Voice" project, together with experts of the LARGIS program (Local and regional government institutional strengthening) will hold seminars in Ivano-Frankivsk and Ternopil on issues related to privatisation of *zheks* (housing and utilities offices in Ukraine). The seminars aim to discuss the methodology and results of housing reform which is going on in these cities. A package of recommendations regarding the future development of this program will be the outcome of these events.

At the seminar which will take place on 18 December in Ivano-Frankivsk, the general goals and the methodology of the program will be discussed.

On 19 December in Ternopil, program participants will define plans for accomplishing the privatisation program of communal-housing enterprises. Representatives of local governments, NGOs, and media from Ternopil, Lviv, and Ivano-Frankivsk will participate in these seminars.

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On 20 December, a conference devoted to problems of educational reforms at the local level will take place in Ivano-Frankivsk. The results of the activity of six working groups in ICPS's project "Reforming education at the municipal level" and future directions will be presented at the conference. The project, launched in May 2000, is ongoing in Ternopil and Ivano-Frankivsk.

On 22 December, a presentation of research on "Reforming the educational policy of Ternopil" will be presented in Ternopil. The research aimed to study the real situation in education at the local level.

For additional information and for obtaining invitations to the seminars please contact Eduard Zakharchenko (e-mail: edward@icps.kiv.ua), tel.: (044) 462-4937/38.

ICPS Newsletter is a weekly publication of the International Centre for Policy Studies delivered by electronic mail. To be included in the distribution list mail to: marketing@icps.kiev.ua.
ICPS Newsletter editor Oleksandr Tsarenok. English text editor D. (Ksenia) Ovcharenko.

The International Centre for Policy Studies is an independent non-profit research organisation with the objective of improving the Ukrainian policy development process.
Web-site: http://www.icps.kiev.ua

- disability retirement is granted too easily;
- the Pension Fund accepts in-kind contributions and even pays benefits comprising non-cash disbursements;
- all working people should pay the same contribution rate if they receive the same benefit;
- the Pension Fund is not reimbursed properly;
- too many social assistance benefits are paid from the Pension Fund.

The course of pension reform in Ukraine

When the government of Ukraine considered creating a mandatory accumulation system to supplement the present system, they considered five objectives:

- smooth out fluctuations in contribution rates or in benefit levels over time;
- privatise pension administration and/or asset management;
- force people to set aside money for their old age;
- depoliticise pension policy;
- increase the supply of money to investors.

On 13 April 1998, the Ukrainian President approved the "Basic Policy on Pension System Reform in Ukraine", supporting the retention of part of the solidarity system to provide basic benefits (the first pillar); a mandatory accumulation system under which people are required to contribute to individual accounts (the second pillar); and a voluntary private system through which people who can afford to may save (the third pillar).

The relative size and strength of the three pillars will depend on the prevailing economic and fiscal conditions.

To implement this three-pillar system—which the World Bank has endorsed as an approach that meets the needs of most countries—the Cabinet of Ministers of Ukraine has developed two draft laws: "On mandatory state pension insurance" and "On non-government pension programs."

In August 2000, the government submitted the Law "On mandatory state pension insurance" to the Verkhovna Rada. The new law makes some fundamental changes to the solidarity system, including raising the pension age, reforming the procedures for calculating benefits, and introducing a mandatory accumulation system.

The following proposed measures will have an impact on revenues and expenditures of the system:

- the statutory pension age will be raised to 65 for males and 60 for females;
- pension payments to privileged pensioners by the Pension Fund of Ukraine will be eliminated over time;
- the period used to calculate average monthly earnings at retirement will be increased, reaching lifetime career wages;
- for the most part, service credits will be granted only for the years in which contributions are actually paid;
- the minimum pension benefit is eliminated and payments to those with low pension benefits will be financed from the state budget;
- the accrual rate per year of service will be reduced;
- disability retirement benefits will now be a percentage of the projected retirement benefit, rather than a percent of wages;
- a new wage cap on wages subject to contributions and used to calculate benefits will be set.

The following measures are to increase pension benefits over time:

- index pension benefits at 20% of the rate of growth of wages, in addition to inflation indexing already included in the law;
- increase the maximum pension benefit;
- beginning after certain economic and administrative pre-conditions have been met, a portion of payroll contributions will be diverted from the solidarity system to a new mandatory accumulation system based on individual accounts.

Fiscal projections of the financial impacts of the draft law show that the solidarity system will be in balance after all the changes are made. The system shows a smaller surplus, due to the diversion of contributions to the mandatory accumulation system, while the ratios of contributors to beneficiaries and average pension to average wage are higher.

Analysis shows that a properly designed mandatory accumulation system offers several benefits to future pensioners and to the government. But these benefits cannot be achieved without costs. The government of Ukraine and the public at large must be aware of not only the benefits of the mandatory accumulation system but also its potential risks. n

For additional information please contact Maksym Mashliakivsky (e-mail: mmax@icps.kiev.ua) or Victoria Yakubovich (e-mail: vyakubovich@icps.kiev.ua), tel. (044) 463-6337/5966.